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Supreme Court, U.S.
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No. 00-776

In The

Supreme Court of the United States

MORGAN STANLEY DEAN WITTER & CO.,

Petitioner,

v.

JAMES ROSKIND,

Respondent.

On Petition For A Writ Of Certiorari To The California Court Of Appeal

BRIEF *AMICUS CURIAE* OF THE SECURITIES INDUSTRY ASSOCIATION IN SUPPORT OF PETITIONER

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BRIEF *AMICUS CURIAE* OF THE SECURITIES INDUSTRY ASSOCIATION IN SUPPORT OF PETITIONER

The Securities Industry Association ("SIA") files this brief *amicus curiae* in support of petitioner, Morgan Stanley Dean Witter & Co.'s petition for a writ of certiorari.[1]

INTEREST OF *AMICUS CURIAE*

The Securities Industry Association is the securities industry's principal trade association, which brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of approximately 50 million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. The industry generates in excess of $300 billion of revenues yearly in the U.S. economy and employs approximately 700,000 individuals.

The SIA and its members, which are federally regulated by the Securities and Exchange Commission

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[1] Written consent of the parties to the filing of this brief has been filed with the Clerk of the Court.

Counsel for a party did not author this brief in whole or in part. No person or entity, other than the *Amicus Curiae*, its members, or its counsel, made a monetary contribution to the preparation and submission of this brief.

("SEC") and the federally-mandated self regulatory system administered by the National Association of Securities Dealers Regulation, Inc. ("NASDR") and the stock exchanges, have a significant interest in ensuring that there is uniformity with respect to the laws on trading practices so as to prevent the creation of 50 different standards with which securities firms (often doing business in multiple states and via the internet) must comply.

In this case, the California Court of Appeal for the First District improperly resolved two issues of vital importance to the interests of SIA members. First, the court wrongly determined that state law causes of action for "trading ahead" and failure to satisfy "best execution" of orders are not preempted by the pervasive federal securities regulatory scheme. Second, the court erred in finding that Sections 17200 and 17500 of the Business & Professions Code, also known as California's Unfair Competition Law, apply to securities transactions. The SIA and its members, especially those members engaged as nationwide broker-dealers, have a substantial interest in the proper resolution of these issues.

ARGUMENT

A. This Court should accept review to resolve the important question of federal preemption and to resolve a conflict among the various lower courts.

The issues presented in the petition for review are twofold. First, there is the question as to whether, in view of the pervasive federal regulatory scheme governing the challenged trading practices, state law challenges to the

manner in which securities transactions are executed by broker-dealers are preempted. Second, there is the important concern as to whether California Unfair Competition Law (Business and Professions Code §§ 17200 et seq.), which is based on the Federal Trade Commission Act, applies to securities transactions. Supreme Court review is necessary to resolve the conflict that exists among various jurisdictions and determine whether the application of California's Unfair Competition Law to securities transactions is preempted.

1. The decision of the California Court of Appeal ignores the fundamental principle that state law challenges to broker trading practices are preempted where those practices are federally regulated as part of the national market system of securities regulation, and conflicts with the decisions of other courts.

The California Court of Appeal for the First District incorrectly failed to apply a preemption analysis with respect to both "best execution" and "trading ahead." This decision is in contravention with the preemption cases of this Court, and conflicts with the decisions of several other cases from various courts including another California Appellate Court and the highest courts of at least three other states.[2]

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[2] *Dahl v. Charles Schwab & Co.*, 545 N.W.2d 918 (Minn. 1996); *Schulick v. Paine Webber, Inc.*, 722 A.2d 148 (Pa. 1998); *Orman v. Charles Schwab & Co.*, 676 N.E.2d 241 (Ill.App. 1 Dist. 1997); *Dumont v. Charles Schwab & Co.*, 717 So.2d 1182 (La.App. 4th Cir. 1998); *Eirman v. Olde Discount Corp.*, 967 So.2d 865 (Fl. App. 4th Dist. 1997); *McKey v. Charles Schwab & Company*, 67 Cal.App.4th

In *McKey v. Charles Schwab & Company*, 67 Cal.App.4th 731 (1998), another California Court of Appeal held that state law challenges to order flow payments were preempted because the 1975 amendments to the Securities Exchange Act of 1934 were intended to promote a national market system for securities regulation, with the oversight of the SEC, and the SEC had promulgated a rule which covered order flow payments, although not specifically mentioning such payments. The Court noted that the rules evidenced "an intent by the SEC to regulate the disclosure of remuneration received by brokers and dealers." *McKey*, 67 Cal.App. 4th at 741-2. The decision below is flatly inconsistent with the decision in *McKey*.

In finding preemption, the *McKey* court relied on *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282 (N.Y. 1996) and *Dahl v. Charles Schwab & Co.*, 545 N.W.2d 918 (Minn. 1996). Both cases recognized not only the SEC's role in monitoring and regulating the practice of order flow payments, but also the danger of defeating Congress' purpose of enabling the SEC to develop and police a coherent regulatory scheme if state courts were allowed to impose civil liability on national securities brokerage firms for failure to meet standards more stringent than federally mandated standards.

The decision of the California Court of Appeal here is not only wholly inconsistent with the decisions of other courts, but also ignores the principle of preemption. As

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731 (Ct.App. 2nd Dist. 1998); *Guice v. Charles Schwab & Co.*, 674 N.E.2d 282 (Ct. App. N.Y. 1996).

with order flow payments, the SEC, by and through NASDR, has carefully examined the issues of "best execution" and "trading ahead" and adopted rules governing both practices within the design of the national market system. *See infra.* Allowing each state to create state law causes of action, which is the intended consequence of the decision of the California Court of Appeal, would disrupt the national market system and confuse the standards. It would, in effect, put the securities industry in the impossible and impractical position of having to comply with a myriad of different regulations, instead of a uniform national standard.

The California Court of Appeal made no effort to conduct a preemption analysis. In error, it relied on the California Supreme Court's decision in *Diamond Multimedia v. Superior Court*, 19 Cal. 4th 1036 (Cal. 1999), for the proposition that Congress contemplated that federal law would only supplement, not replace, state laws which would otherwise apply in the area of securities regulation. *Diamond* is also cited for the proposition that *any* federal remedy is merely a supplement to state law remedies available. Since trading ahead is not affirmatively authorized by either federal civil or criminal law, the Court of Appeal concluded there was no preemption. *See* 80 Cal.App.4th at 353-4.[3]

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[3] The California Court of Appeal also failed to address the contention that plaintiff's "best execution" claims were preempted and addressed the issue of breach of fiduciary duty only in a footnote which stated that that claim was not preempted "for the same reasons." *See* 80 Cal.App.4th at 354, fn. 4.

In contrast to *Diamond* and other cases cited by Morgan Stanley, the California Court of Appeal found there was no SEC rule, NASDR rule, or other federal law or regulation which allows trading ahead. Having determined that no federal regulations allowed the practice, the court made a perfunctory conclusion that a state law allegedly prohibiting the practice was consistent with both the aims and purposes of federal law. However, the court ignored the fact that there is extensive regulation in the practice of "trading ahead," that there is a conflict between the federal regulations as they exist and the cause of action plaintiff has brought, and that the SEC and NASDR have been given the authority to, and have, regulated both "trading ahead" and "best execution."

"Best execution" simply means that a broker-dealer has an obligation to seek to obtain best execution for customer orders. How that duty is to be satisfied has evolved with the changes in the market structure and technology. The SEC has repeatedly emphasized that the appropriate means of ensuring that customer orders receive the best available execution is the disclosure of order information to the market. There is an extensive web of rules and interpretive guidance for members concerning this duty, and the NASDR polices the activities of broker-dealers with respect to whether, in light of certain factors, the obligations regarding best execution have been fulfilled. *See* NASD Notice to Members 97-57 (Sept. 1997), NASD Conduct Rule 2320(a), and Market Report 2000. Additionally, the SEC has issued a release indicating the decided preference to avoid rulemaking regarding order executions so as to avoid potentially cumbersome and outdated restrictions. SEC Release No. 99-146

(November 4, 1999). If an SEC rule on the subject is undesirable to the national market system, state court regulations on "best execution" would constrain every intent of the SEC on this matter, thereby conflicting with the federal scheme. And, in fact, plaintiff's claims on behalf of all California brokerage customers, focusing solely on the price at which a trade is executed, are inconsistent with the case-specific inquiry that the SEC has mandated via the NASDR and are therefore pre-empted by conflict with the federal rules.

Likewise, the area of "trading ahead" has been considered and regulated by the SEC and NASDR. The fundamental rule of conduct regarding commercial honor and just and equitable trading encompasses the practice of "trading ahead," and NASDR determined the practice to be inconsistent with such a rule. The SEC specifically affirmed that determination in several publications. *See* SEC Release No. 25887 (July 6, 1988), No. 34279 (June 29, 1994), No. 35751 (May 22, 1995), NASD Special Notice to Members 95-43 (June 5, 1995), and NASD Conduct Rule Interpretation IM-2110-2. The general rule with respect to the practice of "trading ahead" is that it is prohibited; however, there are several important limitations to that provision. First, it applies only to unexecuted limit orders and does not preclude such trading with respect to market orders. Second, it only applies to market orders that are marketable when received. Third, the trading limit does not apply to after-hours trading. In contrast, plaintiff's blanket challenge contains no such limitations and therefore is in conflict with the federal scheme and regulations.

By ignoring the existing federal regulatory scheme and failing to address preemption, the decision below allows state law causes of action to proceed thereby frustrating the federal goal of a national market system and overriding the well-reasoned distinctions which the SEC, the NASDR, and other self-regulatory organizations have adopted. If allowed, potentially 50 different state standards would arise and national and local brokers would have to adapt to disparate provisions depending on the particular jurisdiction of their client for any given transaction. Such a result would undoubtedly undermine Congress' goal of a national scheme of regulation. State law is preempted if, under the circumstances of the case, the law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress. As this Court has recently reaffirmed, "whether that 'obstacle' goes by the name of 'conflicting; contrary to; . . . repugnance; difference; irreconcilability; inconsistency; violation; curtailment; . . . interference,' or the like" preemption results. *Geier v. American Honda Motor Co.*, 529 U.S. 1913, 1921 (2000) (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)). Inconsistency, conflict and interference will surely result if state law claims such as those at issue here are allowed.

The California Court of Appeal did not have the benefit of two recent decisions of this Court which reaffirmed and clarified conflict preemption. *Geier v. American Honda Motor Co.*, 529 U.S. 1913 (2000) and *Crosby v. National Foreign Trade Council*, 530 U.S. 363 (2000) apply the principles of implied preemption as the California Court of Appeal should have done. *Geier* made clear that a statutory "saving" clause does *not* stand as a bar to the

ordinary workings of conflict preemption principles and does not foreclose a finding that state law claims are preempted, contrary to the holding of the Court of Appeal in this matter. The decision also reconfirmed the doctrine of "frustration-of-purpose" or "obstacle preemption," which the Court of Appeal failed to apply. Likewise, in *Crosby*, this Court emphasized that conflicts between state and federal laws were "not rendered irrelevant by the State's argument that there is not real conflict between the statutes because they share the same goals and because companies may comply with both sets of restrictions." 530 U.S. at 2297. This Court made clear that the fact of a "common end" does not neutralize "conflicting means" and that some companies may be able to comply with both sets of sanctions, "does not mean that the state Act is not at odds with the achievement of the federal decision." 530 U.S. at 2297-2298. The California Court of Appeal ignored the very same argument of Morgan Stanley here. In determining that "the state Act's generality stands at odds with the federal discreteness," it was particularly important in *Crosby* that the state statute penalized some actions that the federal provision explicitly allowed. 530 U.S. at 2297. This is also true for the regulations at issue; plaintiff's causes of action would specifically penalize broker-dealers for actions which the SEC and NASDR have specifically determined to be acceptable. The state action is inconsistent and stands at odds with the federal regulations.

Given the conflict between this California Court of Appeal decision and other high courts in various states, let alone the intra-California conflict, the pervasive federal regulation with respect to both "best execution" and

"trading ahead," the recent decisions of this Court as to preemption, and the inevitable result of confusion if such broad state law claims as plaintiff's are allowed, the decision of the California Court of Appeal should be reexamined by this Court.

2. California Business & Professions Code Section 17200 and other "Little FTC Acts" like it do not apply to securities transactions.

There exists yet another ground upon which this Court should review the California Court of Appeal's judgment: Roskind's unfair competition claims were brought under California Business & Professions Code §§ 17200 and 17500 (California's Unfair Competition Law). These two sections, as well as the other sections of the Business & Professions Code that constitute California's "Little FTC Act," do not apply, and were never intended to apply, to securities transactions. As demonstrated above, federal law has a pervasive national scheme for the regulation of securities transactions. Thus, the application of California Unfair Competition Law based on the federal scheme is preempted by virtue of the resulting conflict. In this case, the lower court did not address this contention. The California Court of Appeal did address the issue, and its view runs contrary to the determination of numerous courts both within California and other states. For example, in *Perera v. Chiron Corp.*, No. C-95-20725SW, 1996 U.S. Dist. LEXIS 22503, *15 – 16 (N.D. Cal. 1996), plaintiff's claim was dismissed and the court held that § 17200 does *not* apply to securities transactions and specifically noted that "the Ninth Circuit

[had] recently affirmed a district court's dismissal of a § 17200 claim on these exact grounds."[4]

There is a clear parallel between California Business and Professions Code §§ 17200 and 17500 and § 5 of the Federal Trade Commission Act (codified at 15 U.S.C. § 45(a)). *Bank of the West v. Superior Court*, 2 Cal. 4th 1254, 1264 (1992); *see Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone Co.*, 20 Cal. 4th 163, 185 (1999) (referring to § 5 of the FTC as "parallel" to §§ 17200 and 17500). As a consequence, the Unfair Competition Law, along with similar statutes in numerous other states, is sometimes referred to as the "Little FTC Act." *Rubin v. Green*, 4 Cal. 4th 1187, 1200 (1993). Thus, decisions by federal courts construing § 5 of the FTC Act are "more than ordinarily persuasive" in guiding construction and application of §§ 17200 and 17500. *Cel-Tech Communication, supra*, at 185 (citing *People ex rel. Mosk v. National Research Co. of California*, 201 Cal. App. 2d 765, 772-73 (1962)); *see also O'Connor v. Superior Court*, 177 Cal. App. 3d 1013, 1018 (1986); *Crowell v. Morgan Stanley Dean Witter Services, Co., Inc.*, 87 F.Supp.2d 1287, 1294-5 (S.D.Fla. 2000).

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[4] *Id.* (citing *Shearson Lehman Bros. Inc. v. Greenberg*, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,409, at 96,227 (C.D. Cal. 1993), *aff'd*, 60 F.3d 834 (9th Cir. 1995)); *accord Feldman v. Glaze*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,450, at 92,892 (N.D. Cal. 1989) (Ingram, J.) ("[i]t is not clear that [§ 17500] is applicable in the securities context"); *Lickhalter v. System Development Corp.*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH ¶ 91,459, at 98,301) (C.D. Cal. 1984) (Kenyon, J.) (dismissing claims on grounds that Section 17200 does not apply to securities transactions).

Federal courts repeatedly have held that the FTC Act does *not* cover securities violations. In *Spinner v. Princeville Dev. Corp.*, 849 F.2d 388, 390-91 (9th Cir. 1988), the Court stated that the FTC Act "has not been applied in a securities context since 1923." More recently, the Ninth Circuit reinforced this trend in an unpublished decision. *Shearson Lehman Brothers*, 1995 U.S. App. LEXIS 17313, *4 (9th Cir. 1995) (holding "that Cal. Bus. & Prof. Code 17200 is inapplicable to securities transactions"). All other Circuit Courts of Appeal to decide the issue agree. *See Stephenson v. Paine Webber Jackson & Curtis, Inc.*, 839 F.2d 1095, 1101 (5th Cir. 1988) ("The FTC Act has been interpreted to preclude coverage of securities claims"), *cert. denied*, 488 U.S. 926 (1989); *Lindner v. Durham Hosiery Mills, Inc.*, 761 F.2d 162, 167 (4th Cir. 1985) ("no federal court decision has applied § 5(a)(1) of the FTC Act to securities transactions"). Moreover, as Judge Williams noted in *Perera*, state and federal courts in at least 16 other jurisdictions have refused to apply other states' Little FTC Acts to securities transactions. *Perera*, 1996 U.S. Dist. LEXIS 22503, at *16.[5]

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[5] *See also Bulgo v. Muñoz*, 853 F.2d 710, 714 (9th Cir. 1988) (Hawaii law); *Stephenson v. Paine Webber Jackson & Curtis, Inc.*, 839 F.2d 1095, 1101 (5th Cir. 1988) (Louisiana law); *Smith v. Cooper/T. Smith Corp.*, 846 F.2d 325 (5th Cir. 1988) (Louisiana law); *Swenson v. Engelstad*, 626 F.2d 421 (5th Cir. 1980) (Texas law); *Caraluzzi v. Prudential Sec., Inc.*, 824 F. Supp. 1206, 1215 (N.D. Ill. 1993) (Connecticut law); *Wyman v. Prime Discount Sec.*, 819 F. Supp. 79, 87 (D. Me. 1993) (Maine law); *Joyner v. Triple Check Fin. Serv.*, 782 F. Supp. 364 (W.D. Tenn. 1991) (Tennessee law); *Mercer v. Jaffe, Snider, Raitt & Heuer, P.C.*, 713 F. Supp. 1019 (W.D. Mich. 1989) (Michigan law), *aff'd*, 933 F.2d 1008 (6th Cir. 1991); *Nichols v. Merrill Lynch, Pierce, Fenner & Smith*, 706 F. Supp. 1309, 1325 (M.D. Tenn. 1989) (Tennessee law); *Takiguchi v. Podorean*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH)

With such a pervasive federal scheme for securities, and the universal agreement among the federal courts, it is only natural that many California trial courts have found that §§ 17200 and 17500 should not be applied to securities transactions. *See Copperstone v. TCSI Corp.*, No. 775199-1 (Alameda County Super. Ct. Apr. 2, 1997) (concluding "as a matter of law that California Business & Professions Code sections 17200 and 17500 do not apply to securities transactions"); *Howard Gunty Profit Sharing v. Quantum Corp.*, No. CV760370 (Santa Clara County Super. Ct. Feb. 28, 1997) (same); *Ferrari v. Read-Rite Corp.*, No.

¶ 93,319, at 96,625 (D. Haw. 1987) (Hawaii law); *Morris v. Gilbert*, 649 F. Supp. 1491 (E.D.N.Y. 1986) (New York law); *Robertson v. White*, 633 F. Supp. 954 (W.D. Ark. 1986) (Arkansas and Oklahoma law); *Singer v. Dean Witter Reynolds, Inc.*, 614 F. Supp. 1141, 1145 (D. Mass. 1985) (Massachusetts law); *In re Catanella Sec. Litig.*, 583 F. Supp. 1388 (E.D. Pa. 1984) (New Jersey law); *Taylor v. Bear Stearns & Co.*, 572 F. Supp. 667 (N.D. Ga. 1983) (Georgia law); *Russell v. Dean Witter Reynolds, Inc.*, 510 A.2d 972 (1986) (Connecticut law); *Skinner v. E.F. Hutton & Co.*, 333 S.E.2d 236 (N.C. 1985) (North Carolina law); *State ex rel. McLeod v. Rhoades*, 267 S.E.2d 539 (S.C. 1980) (South Carolina law); *Kittilson v. Ford*, 23 Wash. App. 402, 595 P.2d 944 (Wa. App. 1979), *aff'd*, 608 P.2d 264 (Wa. 1980) (Washington law); *State v. Piedmont Funding Corp.*, 382 A.2d 819 (R.I. 1978) (Rhode Island law). The few courts that apply Little FTC Acts to securities transactions do so under circumstances very different from those presented here. For example, Illinois' Little FTC Act by its very terms applies to securities transactions. *See Preston v. Kruezer*, 641 F. Supp. 1163, 1167 (N.D. Ill. 1986). Similarly, the Arizona and Massachusetts Legislatures explicitly overruled opinions that refused to apply that state's Little FTC Act to securities transactions by amending their statutes. *See State ex rel. Corbin v. Pickrell*, 667 P.2d 1304, 1306 (Ariz. 1983); *Ansin v. River Oaks Furniture, Inc.*, 105 F.3d 745, 760 (1st Cir.), *cert. denied*, 118 S. Ct. 70 (1997).

CV762735 (Santa Clara County Super. Ct. May 20, 1997) (same); *Goldberg v. Storm Technology, Inc.*, No. CV764797 (Santa Clara County Super. Ct. Aug. 25, 1997) (same). To hold otherwise necessarily conflicts with the federal scheme of securities regulation.

Finally, California's own securities laws provide further confirmation that §§ 17200 and 17500 do not apply to securities transactions. In 1968, the California Legislature enacted the Corporate Securities Law (codified at Cal. Corp. § 25510) of which Professor Harold Marsh, Jr. and former Corporations Commissioner Robert H. Volk were the principal drafters.[6] In their treatise, they state that "any cause of action for misrepresentation in connection with a securities transaction, other than strict common law fraud or an action for rescission based upon traditional equitable principles, will have to be brought under these provisions of the Corporate Securities Law of 1968." 1 H. Marsh & R. Volk, *Practice Under The California Securities Laws* § 14.02[2], at 14-17 (1999). For this reason as well, no claim for securities violations may be brought under §§ 17200 and 17500.

The decision to reverse the overwhelming trend that California's Unfair Competition Laws should not be applied to securities transactions should not be made lightly, nor should it be made in half steps. Despite the demonstrably long and unbroken line of local state and federal authority to the contrary, the California Court of

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[6] Recognizing their unique role in drafting the Corporate Securities Law, the California Supreme Court accords substantial deference to their views. *See Mirkin v. Wasseman*, 5 Cal. 4th 1082, 1103 n.10 (1993).

Appeal for the First District rejected this notion in a single, brief footnote. 80 Cal.App.4th at 356, n. 8. The court's decision will undoubtedly invite a deluge of securities litigation that will swamp already overburdened state courts and subject broker-dealers doing business in California and many publicly traded California companies to uncertain liability. The decision also threatens to start the nation's courts down a slippery slope in which a once homogenous treatment of securities transactions fragments into uncertainty and potentially onerous differential liability in each jurisdiction evolves. This would both threaten to reverse the nation's movement toward the national market which Congress has sought through the enactment of the National Securities Market Improvement Act of 1996 and the Securities Litigation Uniform Standards Act of 1998, and promote confusion across the nation as brokers scramble to ascertain whether and when such a decision affects them in each transaction they enter. More dramatically, allowing the upset of a seemingly settled area of California law may both affect the California economy (triggering a flight of existing companies from and slowing the flow of companies emigrating to California) and cause other courts and state legislatures to take pause regarding this issue. Given the importance of California's public companies to its economy, the upheaval that will certainly ripple through the national economy, and the importance of national securities regulations, the unprecedented and aggressive expansion of state-law liability undertaken by the Court of Appeal warrants review.

CONCLUSION

This Court has the opportunity to reexamine the decision of the California Court of Appeal and clarify several important issues for the courts of the country. A large number of SIA members conduct business in numerous jurisdictions, including California. California has a very significant role and impact on the financial services industry. Review by this Court is important. First, the Court can and should resolve the conflict that exists among the various lower courts. Second, the Court should review the pervasive federal regulatory scheme regarding the practice of trading ahead and the requirements of best execution and determine whether plaintiff's sweeping causes of action are preempted. Finally, the Court should review the history and origins of California's Unfair Competition Law, embodied in Business & Professions Code § 17200, and decide whether it does or does not apply to securities transactions. The SIA urges this Court to accept review and resolve these important issues.

Respectfully submitted,

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